THE STATE OF NEW HAMPSHIRE
Before the
PUBLIC UTILITIES COMMISSION

Verizon New Hampshire's	)	DT 02-110
Cost of Capital	)	

POST-HEARING BRIEF BY OFFICE OF CONSUMER ADVOCATE

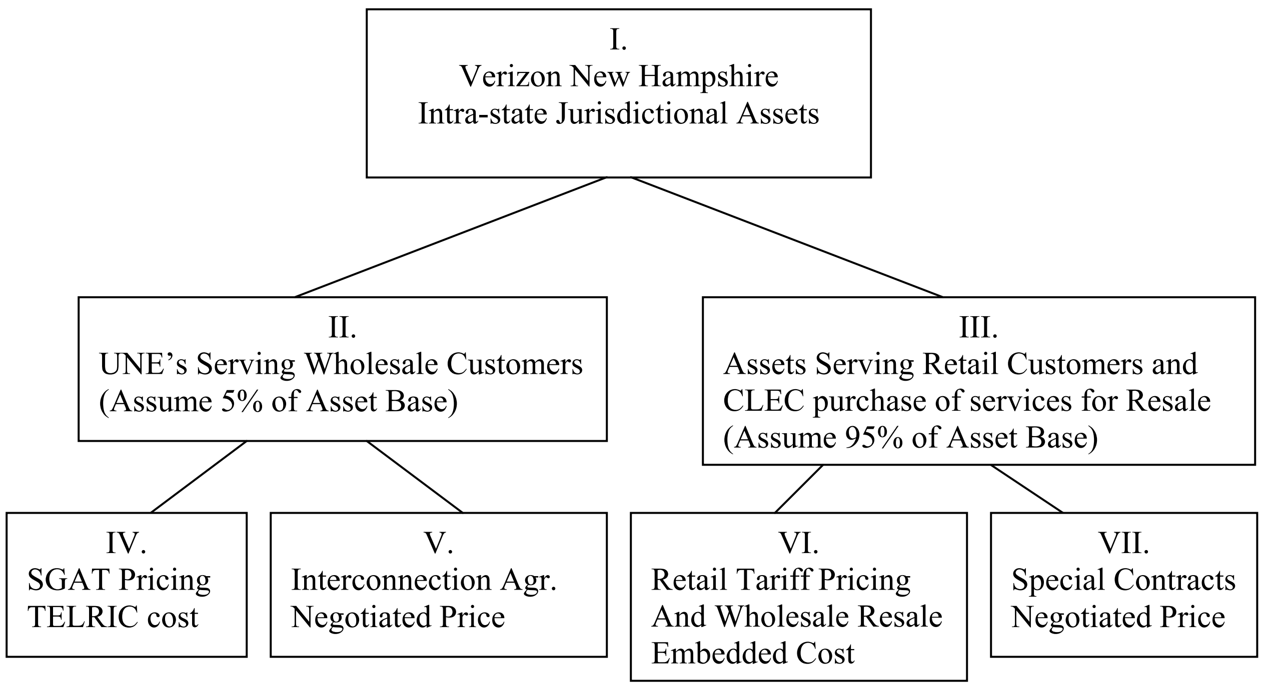
The Office of Consumer Advocate ("OCA") files this Post-hearing brief in order to address a number of legal issues underlying the Commission's determination of an appropriate cost of capital for Verizon New Hampshire ("Verizon"). In its Order No. 24,089 dated November 27, 2002, the Commission clarified the scope of this proceeding, "[t]he purpose of this docket is to determine Verizon's cost of capital for retail ratemaking and UNE ratemaking." As a result, the cost of capital in this docket is to be set for both Verizon-NH's retail services and for its UNE's (Unbundled Network Elements) offered to Competitive Local Exchange Carriers ("CLEC's") pursuant to 47 U.S.C. Section 251. ("96 Act").

Introduction

As revealed by the record in this case, one of the primary considerations in determining the cost of money is the risk attached to the investment of that money. For investments in regulated entities the level of risk is, in part,[1] a function of how the investment is treated in the ratemaking process. This Commission must therefore first look at how UNE's will be treated in a future rate case to determine whether the regulatory process exposes the UNE business to any different risk than Verizon's retail business does.

As illustrated in the diagram shown below, Verizon has a group of jurisdictional assets located in New Hampshire that are subject to Commission regulation ("NH Plant").

DIAGRAM OF VERIZON's NH PLANT AND THE SERVICES IT SUPPORTS



[1] There are many other factors aside from regulatory treatment that determine investment risk—a primary factor is whether or not the company functions as a monopoly provider of service.

That NH Plant serves both retail and wholesale Verizon customers. Currently Verizon reports its expenses and revenues on its NH Plant without separating assets and related expenses used to support UNE's from assets and expenses used to support retail services.[2]

Under the current regulatory scheme in New Hampshire Verizon's retail rates were set based upon embedded costs in Docket DR 89-010 about thirteen years ago. Rates were set before passage of the 96 Act and therefore wholesale UNE rates were not considered as part of the 1989 Verizon rate case. Since that time Verizon has not had a subsequent retail rate case and retail rates have remained largely unchanged except for adjustments for extended area calling and other minor items. In 1997 Verizon filed an SGAT (Statement of Generally Available Terms) and began offering services to CLEC's. Since the 1989 Rate Case the Commission has received and reviewed Verizon's monthly and annual financial filings and has calculated Verizon's intrastate earnings against its total intrastate rate base. Verizon's intrastate revenues have included both retail and wholesale revenues. Verizon's UNE pricing is determined by the current NH SGAT, including a stipulated rate of return and, to date, Verizon's UNE rates and UNE rate base have not been addressed in a rate case.[3]

In this docket the Commission should consider the need for, and impact of, a different rate of return for retail and UNE rates. Verizon NH retail rates are set based upon historical investment, i.e. actual embedded costs, whereas wholesale UNE rates are set based upon the TELRIC methodology which assumes a hypothetical telephone network and therefore, for the

---

[2] The NH Plant also supports interstate services and the FCC approves separations to account for this shared use. For purposes of this discussion we will ignore the subset of interstate services which would be excluded from a NH rate case.

[3] It is also worth noting that for instance, not all wholesale services are subject to UNE rate of return. CLEC's purchasing Verizon's services for resale will not be effected by the UNE rate of return. Resale rates for CLEC's are calculated by applying a discount, representing an approximation of Verizon's avoided costs, to Verizon's retail rates.

most part, ignores imbedded or historic costs.[4] Although Verizon repeatedly claims, through its expert witness in this proceeding, that its TELRIC rates in New Hampshire are not sufficient to recover its historical investment, there is absolutely no numerical evidence in this docket to support those claims. Verizon's claims of under-recovery are purely theoretical and are based on many assumptions which do not mirror the facts. Further, under Verizon's current financial reporting format it is not possible to determine whether or not Verizon's current UNE rates are recovering its actual investment in the facilities serving UNE customers. Finally, in the case of UNE rates for NH residential customers, CLEC's in DT 01-151 (Verizon's NH 271 proceeding) claimed that UNE rates are higher than tariffed residential rates creating a price squeeze and preventing CLEC's from competing for residential customers in NH. Based upon these CLEC claims it is hard to imagine that Verizon is not recovering its actual costs through its UNE rates for residential customers.

Since Verizon does not currently report its UNE assets and expenses separately, when the Commission reviews Verizon earnings it is reviewing total revenue and expenses against Verizon's total jurisdictional plant, based upon actual historic investment. As a result, Verizon NH is currently receiving regulatory review which insures that it receives an appropriate rate of return on its total historic investment in NH Plant. Before it sets a retail or UNE rate of return for Verizon, the Commission should consider whether it will continue this treatment of all Verizon's intrastate assets in the future or whether it intends to impose some separation of assets based upon which service those assets support. The Commission's regulatory approach will, to a certain extent, determine Verizon's level of investment risk.

---

[4] TELRIC pricing is based to some degree on embedded assets, e.g. the current configuration of central office switches and trunk lines must be assumed to exist in the "future" plant.

Argument

1. Ratemaking Approach Impacts Verizon's Investment Risk

The OCA envisions two alternative regulatory approaches the Commission might take in a future rate case. Each approach creates different risks for Verizon.

Option A. Treat all NH plant as a whole without separating UNE Assests.

The Commission could continue to treat all intrastate assets, category I, as a group and apply the retail rate of return, or as some might recommend a blended retail/UNE rate of return, to those assets to set Verizon's retail rates. A blended rate of return could be accomplished based upon a weighted average of the retail and UNE rates of return. The weighting should correspond to the percentage of intrastate assets used to support UNE's, category II, as compared to the assets used to provide retail services, category III.

Option B. Treat Retail Assets, Category III, Separately from UNE Assets, Category II

The Commission could require Verizon to separate the assets and related expenses serving UNE's, category II, from the assets serving retail customers, category III.. The Commission could then conduct a rate case to determine the rate base in category III and assign the retail rate of return to that rate base giving Verizon a reasonable rate of return on its actual historic investments. For UNEs, the Commission would rely upon the established UNE rate or interconnection rates for the revenue on UNE assets, category II, and impose the burden of any shortfall on actual costs of UNE's upon Verizon.[5]

If the Commission were to take Option A, the return, whether retail or a blended retail/UNE return, would be applied to the actual rate base, and therefore Verizon's risk would be minimal. Option A insures that Verizon will receive all the actual costs involved in its UNE business just as it does in its retail business. This arguably is a better deal for Verizon than the risks entailed in treating UNE's as a stand-alone business, where Verizon, according to its expert witness, can earn a lower-than-expected rate of return. Even if Verizon doesn't earn its allowed return as they claim, the Company doesn't loose money, it just doesn't make as much profit as it believes it should. That is, its profit is lower, not negative.

On the other hand, retail rate payers under Option A will pick up any UNE under recovery in retail rates. Under Option A, however, allowing a higher return on UNE's, based on a higher theoretical risk, means that ratepayers in a rate case will need to provide a smaller subsidy to UNE's, if any is required, because the higher price of UNE's would contribute more to total revenues. Finally, under Option A applying a blended rate of return would create a windfall for Verizon if the UNE rate of return were higher than the retail rate of return. This is because under Option A the return is applied against the total rate base, including that use to provide UNEs. As a result, Verizon has no risk of under recovery due to TELRIC pricing under Option A.

In contrast, Option B, would require that all items of rate base, revenue, and expense related to UNE's, as well as any higher capital costs, be separated from retail rate base, revenue and expenses. This means, in effect, using a rate case analysis for UNE sales and comparing historic or actual costs to UNE revenues to determine the net income. This would be done at the same time, but separately from a rate case on retail rates. In order to carry out Option B a cost study would have to be done on UNE's. Verizon would then have either a positive or negative return on the UNE business when measured against its actual costs. Under Option B, the Commission would treat the gain or loss on UNEs separately from the retail side of the rate case.

---

[5] The Commission should apply the UNE rate of return to TELRIC investment and not on

OCA believes that any UNE shortfall should be bourne by Verizon shareholders. Option B leaves only the risk of UNE losses due to TELRIC pricing on Verizon. This is because, all other assets not used to support UNE's, i.e. category III, would be included in the retail rate case. As a result, Verozon would be subjected only to normal regulatory risk on its recovery of the actual costs of category III assets.

OCA believes that having Verizon shareholders bear any investment recovery shortfall on UNEs under Option B is consistent with the 96 Act. When the 1996 Act granted the Regional Bell Operating Companies, ("ILEC's") access to the interstate long distance market, those additional revenues and profits were intended to offset any revenues and profits lost in local exchange by sale of UNE's. The very fact that under the 96 Act, Verizon is required to compete with UNE customers (CLEC's) means that Verizon is at risk for any UNE shortfall. To have ratepayers subsidize the UNE business would remove Verizon from the very risk it claims is higher for its UNE business. By requiring UNE pricing at cost efficient TELRIC costs, the 96 Act forces Verizon to compete. Competition and its consequences should not be the responsibility of customers remaining under regulated rates. For these reasons, under Option B, in a rate case retail ratepayers should not be responsible for any loss attributable to the cost of the UNE business. It will be essential in protecting retail ratepayers from UNE losses that the Commission require an appropriate cost study for UNE's and direct Verizon at this time to henceforth maintain adequate records to allow separations in future dockets.

Under either Option A or B, Verizon may not claim that CLEC's terminating UNE leases create a special additional risk. Those UNE assets, following a CLEC lease termination, are either re-leased by another CLEC, or are unused by CLEC's and returned to the group of

---

embedded or actual costs.

regulated retail assets available to retail customers. This scheme would only fail if Verizon had created so much excess capacity in its network that the Commission determined that some assets were not used and useful to retail ratepayers. This scenario seems unlikely since Verizon claims in this docket that it does not build to CLEC demands and is sizing its network facilities to meet reasonable retail demand.

In conclusion, under Option A Verizon faces no additional risk in its UNE business since it earns its retail rate of return on its total NH Plant. Under Option B, the only risk which Verizon has identified in this proceeding is the risk that TELRIC pricing in NH may not equal or exceed Verizon's actual costs of providing UNE's. Verizon has not attempted to quantify this claim that actual costs of UNE's are not recovered. In order to quantify this risk Verizon would need to produce actual cost studies for its NH UNE's. Since this claimed risk is not quantified by Verizon and because in some cases NH UNE rates are equal to or exceed retail tariff rates, the Commission should not find any risk premium necessary for Verizon's UNE business.

For the present time the OCA recommends that the Commission use Option A with a straight retail rate of return applied to total rate base. As discussed earlier, the blended rate of return, if UNE returns are higher than retail returns, merely creates a windfall for Verizon. At this point the assets supporting UNE's are minimal compared to total rate base and therefore the subsidy, if any, retail ratepayers are burdened with is insignificant. Further, the resources and administrative cost involved in an adequate separations and cost study are extensive, making it unlikely to produce any cost benefit to ratepayers when the UNE business represents such a small portion of total rate base. In the event the assets serving UNE's increase significantly, then the Commission should consider Option B.

2. Verizon's Option Theory is Untested and Ignores Regulatory Reality

Verizon through its expert witness, James H. Vander Weide, argues in this proceeding that Verizon encounters an additional risk as a result of the requirement that it offer UNE's to CLEC's.

"My estimate of the weighted average cost of capital for these companies is 12.45%. However, this estimate does not consider the additional risk Verizon NH faces for making long-term fixed investments in network facilities while offering its customers the option to cancel their lease contract on a monthly basis. …

To reflect the additional risk of making long-term fixed investments in a telecommunications network, while offering customers an option to cancel their lease contract on a monthly basis, the weighted average cost of capital for use in UNE cost studies must be greater than the weighted average cost of capital for my proxy group of industrial companies. I estimated the additional return required to compensate Verizon NH for the unique and special risks it faces in offering competitors an option to cancel their lease on a monthly basis by applying option pricing formulas used by many financial market participants. My estimate of the required risk premium is 5.48%. Thus, my recommended cost of capital for use in UNE cost studies used to set Verizon NH's rates is 17.93% (12.45% + 5.48% = 17.93%)." Direct Testimony of James H. Vander Weide, p. 8 lines 2-18.

As discussed in section 1 above, this analysis ignores the regulatory context Verizon operates in and is not consistent with either of the regulatory options the Commission is likely to pursue in a Verizon rate case. Verizon's option analysis assumes that the party offering the option, in this case Verizon, encounters a risk that the option will not be exercised, i.e. that the UNE lease will be terminated, before it is paid for. This option theory does not reflect real risks faced by Verizon in leasing UNE's. First of all, when a UNE lease is terminated, it may be picked up by a new CLEC on a UNE lease; moreover, under the Company's assumption of full competition, the UNEs would <u>certainly</u> be re-leased by another CLEC. If the assets supporting the UNE are not leased to a CLEC, then they return to regulated rate base, category III. As part of regulated rate base Verizon will earn a reasonable rate of return on these assets. As explained above this regulatory protection of UNE assets returning to regulated rate base would only fail if the excess capacity was so extreme that the Commission found that certain assets were no longer used and useful to retail customers. In this case an extreme excess capacity situation is very unlikely. Verizon has made it clear that it does not deploy facilities to meet CLEC requests.

BR/Conv. Data Request 1-10 to Verizon

"….(a) To what extent does Verizon deploy facilities to accommodate CLEC requests for UNEs?

(b) Does Verizon deploy facilities upon a CLEC request for a given UNE and/or when there are no UNE facilities available?

(c) Has Verizon specifically made separate network investments to provide UNEs to CLECs that would not have been made except for the need to service CLECs? If yes, please state the total amount of such investment both to Verizon consolidated and to Verizon in New Hampshire…."

Verizon Response

"….(a) Verizon provides no discriminatory access to Unbundled network Elements where facilities are available and to the extent technically feasible.

(b) No.

(c) No…."

BayRing/Conversant Data Request 1-10 and Verizon Response

Based upon this response it is clear that Verizon does not make capital investments for CLECs. Further, Verizon is not obligated to provide UNEs where facilities are unavailable. As a result, the regulatory reality is very different than the assumptions underlying Verizon's request for an additional risk premium. Verizon is not making any long term capital investments in order to serve CLECs. Verizon, under either of the rate case options discussed above, is not at risk for recovery of any assets not serving CLECs. Those assets are part of the Verizon's retail rate base and are recovered through retail rates. If any underrecovery is occurring Verizon is free to request a rate case and adjust retail rates accordingly.

There are several other significant ways in which Verizon's option theory does not reflect reality. First a stock option is not like the tangible telecom network built by Verizon. Stock options are speculative investments whereas the telecom network "has some intrinsic economic and societal value as an on-going business enterprise or it would not have been built." Exhibit 47 Direct Testimony S. Hill p. 65 lines 26-27. Second, stock options generally have a term of several months to a year, while Verizon's telecom network has an economic life of about 16 years. Moreover Verizon assumes, for purposes of calculating a risk premium, a stock option with a term of 16 years – something that doesn't actually exist. Finally, Verizon's assumption that UNEs will not be leased is contrary to the assumption of a fully competitive market which underlies Verizon's lease/option/risk premium analysis. Id. at p. 66.

In addition to not reflecting regulatory reality, Verizon's option theory is unorthodox and is a dramatic and unexplained change from the prior testimony of Verizon's expert witness. Verizon's witness admitted that this is the first time he has filed expert testimony recommending a 5% risk premium for UNE cost of capital. Transcript Day II p. 128. Verizon's witness has filed cost of capital testimony specifically related to UNEs 36 times and this is the first time he has recommended any sort of risk premium for UNE's. Verizon's witness also admitted that if this overall cost of capital of 17.93% were applied to Verizon New England's actual capital structure it would result in a cost of equity of 31%. Transcript Day II p. 129-130. A cost of equity in this range for a rate regulated entity is unheard of. Verizon tries to justify this high return by claiming that Verizon would not actually have the opportunity to earn this rate of return due to the TELRIC pricing rules. Transcript Day II p. 130.

What Verizon is attempting to do in this cost of capital docket is to set a cost of capital too high in order to make up what it perceives to be a shortfall in its recovery on UNE's due to the forward looking nature of TELRIC pricing. If Verizon had taken any steps to quantify this alleged short fall in TELRIC prices this testimony might have some meaning, however, no such evidence was presented to support these claims. Even if one were to accept, for purposes of argument, that NH SGAT prices for UNE's do not recover embedded costs, that is not necessarily a reason to adjust the cost of capital.

3. Verizon's Cost of Capital should be at the Lower End of the Reasonable Range

The latest and most comprehensive review of the law applicable to ratemaking and cost of money issues in New Hampshire is found in Appeal of Conservation Law Foundation, 127 N.H. 606 (1986). The starting point of the Court's review recognizes,

> " The Commission is bound to set a rate of return that falls within the zone of reasonableness, neither so low as to result in a confiscation of company property, nor so high as to result in extortionate charges to customers. LUCC, 119 N.H. at 341-42, 402 A.2d at 630" Id at 635.

Next, the Court notes that the lower boundary of that zone would be

> "A rate falling within that zone should, at a minimum, be sufficient to yield the cost of the debt and equity capital necessary to provide the assets required for the discharge of the company's responsibility. See, New England Telephone & Co. vs. State, 104 N.H. at 232, 234, 183 A.2d at 240, 241, Company v. State, 95 N.H. 353, 361, 64A 2d 9, 16 (1949)." Id at 635. (empasis added).

Subject to exceptions for a hypothetical capital structure and making allowance for increased or decreased efficiency of management, Id at 635-636, the upper boundry is

> "[A] rate sufficient to yield a return comparable 'to that generally being made at the same time and in the same general part of the country on

> investments in other business undertakings which are attended by corresponding risks and uncertainties [.]' Bluefield Co. v. Pub. Service Comm., 262 U.S. 679, 692, (1923); New England Tel. & Tel. Co. v. State , 113 N.H., 92, 95, 302A 2d 814, 817 (1973); New England Tel & Tel.Co. v. State, 104 N.H. at 234. 183 A 2d at 241; New England Tel. & Tel. Co. v. State, 98 N.H. at 221, 97 A 2d at 221; Chicopee Mfg. Co. v. Company, 98 N.H. 5, 13; 93A.2d 820,826 (1933), overruled on other grounds, 119 N.H. 359, 366, 402 A.2d 644,649 (1979); C. PHILLIPS, Jr., supra at 339". Id at 635.

This is the so called "comparable earnings" test, a test which also excludes "returns commensurate with 'highly profitable enterprises or speculative ventures'." Appeal of Public Service Co. 130 N.H. 748, 756 (1988).

The Court also recognizes that "the actual needs of the company do not control". Id at 635. For example, the Commission can recognize managerial efficiency or inefficiency or use a hypothetical capital structure instead of the actual " because the object of the process is to strike a fair balance between recognizing the interests of the customer and those of the investor", e.g. more equity in a capital structure than necessary is simply more costly to ratepayers than necessary. Nor is the Commission even required "to guarantee bondholders their interest or stockholders their dividends" Id at 635.

Turning now to applying the above principles to the facts in this case the OCA first notes that Mr. Hill summarizes his multi-faceted analysis of cost of equity based on comparable earnings by concluding:

> "Therefore using the upper bound of a reasonable range of equity cost estimates for gas distributors of 10.50% and the lower bound of a reasonable range of equity cost estimates for telecom holding companies, 11.75%, the cost of equity capital of a local exchange telephone company can be said to fall between 10.50 and 11.75%" Exhibit 47, page 52.

Based on judgment and other factors applied to his different methodologies, Mr. Hill recommends 10.875% as the correct allowable return based on his various comparable earnings tests. Exhibit 47, page 53. But based on the principles in Conservation Law Foundation and the unique facts here, the OCA submits that the Commission should set the cost of equity at the lowest reasonable level provided by Mr. Hill in this proceeding as discussed below.

First, Mr. Hills' as well as other studies in this case are fundamentally an attempt to find an appropriate return for comparable risk, a return which is more than sufficient to attract capital. These comparable earnings methodologies do not recognize the minimum equity return of the "zone of reasonableness", which is only the level of return needed to attract capital necessary for the company to discharge its responsibilities.

From 1994-2001, Exhibit 48 reveals a Verizon New England Total Investment of $8,880,090,000 (the line that reads Net Cash Provided by/Used in Invest Activity) in the company of which $8,566,591,000 was in plant and equipment. At the same time depreciation and amortization accounted for a cash flow of $7,832,435,000 meaning the lion's share, or roughly 88% of Total Investment, came from this single source of internally generated funds. Basically this means Verizon only had to raise another $1,048,574,000 over this eight year time frame, to achieve the Total Investment it made.

What is more, 91% of the entire investment in property, plant and equipment came from depreciation and amortization. This means Verizon needed only $734,156,000 to provide for its whole investment in property, plant and equipment over this eight-year period.

While Exhibit 48 reveals some new affiliate debt, third party debt and new equity amounting to $1,788,728,000, total net income for the period was $3,687,257,000. None of this additional financing was necessary.

Had Verizon simply refrained form taking all of its net income, and more, out in dividends, i.e. $4,473,874,000 in dividends, it had more than enough internally generated funds to cover all its capital needs. In fact, it could have covered its acquisition of property plant and equipment from depreciation, amortization, and income alone -- and still had $2,953,101,000 left in income available for dividends.

Instead, as observed, Verizon New England paid out $4,473,874,000 in dividends to its parent company, Verizon, on income of $3,687,287,000, or roughly $800,000,000 more in dividends than it earned.

Verizon does not need to attract any outside capital to the company to discharge its responsibilities. Without the need to attract capital for a growing concern, not even the low end of the "zone of reasonableness" is necessary for Verizon. Even on the basis of meeting the capital attraction test in the zone of reasonableness, the return on equity Verizon has historically needed to meet its responsibilities was less than half of what it earned, as observed by comparing total income of $3,687,257,000 to the income necessary to fill the gap between depreciation, amortization, and total investment, of $1,788,728,000.

A further consideration in determining the cost of equity, as noted earlier, is management efficiency or inefficiency. One measure of inefficiency is a failure to meet franchise obligations and provide improved or enhanced service. In this respect the following Verizon testimony by Dr. Vander Weide is significant.

> "Q. Do you have any evidence that Verizon is reducing its capital expenditures as a result of its inability to earn a fair rate of return?
>
> A. Yes. In a recent discussion with analysts, Verizon CEO Ivan Seidenberg noted that Verizon cut its capital spending by 30% in 2002, and that capital spending may contract further if the company does not get more favorable regulation." Exhibit 2, page 40.

Two conclusions can be drawn from this testimony. Most obvious is that Verizon is refusing to make what it believes to be necessary and needed capital expenditures. Otherwise, the comments have no significance. Second, is that Verizon therefore concedes that it is not doing what it is supposed to pursuant to its franchise in order to improve, enhance, or even maintain, the required level of service to customers. Regardless of the motive for this inefficient management the Commission is entitled to, and should, reduce its rate of return accordingly. Mr. Seidenberg may understand his obligations to stockholders, but apparently not to ratepayers. The Commission and the Courts, not he, determine the return to stockholders. His option is to yield Verizon's franchise if he fails to accept the appropriate regulatory principles. Instead of bowing to Mr. Seidenberg's threats, the Commission should limit Verizon NH's dividends and reduce the return on equity to one that recognizes both inefficient management and the lack of need to attract external capital.

On the other hand, perhaps Mr. Seidenberg's comments are simply opportunistic threats and merely reflect the reality that Verizon no longer needs to expand its business or attract capital because it has passed its "zenith of its opportunity". In this context it is worth noting that to the extent Verizon faces the dangers of competition that expose it to higher business risks than gas distribution companies, it is not the responsibility of ratepayers to make Verizon whole by increasing its allowed return on equity to meet its increased risk. Doing so is not a reasonable return but "plenary indemnification". See, Appeal of Public Service Co. 130 N.H.. 748, 755 (1988).

In Market Street R.Co. v. Comm'n, 324 U.S. 548, 566 (1945) competition from an unregulated street car competitor a couple of blocks away produced a situation whereby increasing regulated rates even higher would have only accelerated its demise because it had passed the "zenith of opportunity" due to market forces. See also, Petition of PSNH, 130 N.H.. 265, 277 (1988). In this case, Verizon has emphasized that "local exchange competition is extensive throughout New Hampshire" Exhibit 1, page 40. "To be sure the combination of demand uncertainty and rapidly changing technology has forced many companies in the telecommunications business into bankruptcy in recent years." Exhibit 1 page 47. The kind of "returns commensurate" with these risks are those of "speculative ventures." Supra, page 12.

To take the above reasoning to its logical conclusion, first Mr. Hill's comparable earnings test based on gas distribution companies is the appropriate benchmark for Verizon. Second, Verizon is simply not entitled to a "shifting of risk after risk materialized" onto its ratepayers due to market forces. Appeal of Public Service Co. 130 N.H. 748, 755 (1988). A comparable return to that of telephone companies facing cellular and other local competition would do just that. Thus the only acceptable starting point for comparable earnings is the 10.50% upper end for gas distribution return calculated by Mr. Hill for a utility that has similar restructuring risks and competitive alternatives. Exhibit 47, page 30. To repeat, the use of telephone companies as comparable risk examples, in effect transfers the increased risk to ratepayers.

Moreover, the actions of Verizon's top management and its lack of need to attract capital would require the Commission to reduce even that number significantly. Therefore, the Commission should adopt a cost of equity using the low end for gas distribution companies based on a composite of the 4 methodologies Mr. Hill used for a cost of equity to gas companies as summarized at Exhibit 47 page 51. The average low end for cost of equity for gas utilities using a CAPM of 8.23%, a Modified Earnings/PE analysis of 8.96%, a market to book ratio analysis of 10.28% and a DCF of 10.46% produces a more appropriate cost of equity for Verizon of 9.48%. Adopting this 9.48% cost of equity along with Mr. Hill's recommended debt/equity ratio of 55/45 and an embedded debt cost of 7.051% produces an overall return for Verizon of 8.14%. OCA believes that based upon the all the facts and circumstances presented in this docket, this is a reasonable rate of return for Verizon and should be used in determining retail rates.

While the studies and methodologies Mr. Hill relied upon encompass a broad range of accepted methodologies, the same can not be said for Verizon. Verizon went so far to promote a higher return as to trap itself into circular reasoning. As noted by Mr. Hill at Exhibit 47, page 58, Verizon employs a methodology for determining investor dividend growth expectations whereby regulators are actually asked to increase dividend growth expectations, and thus cost of equity, by fulfilling investors desire for increased dividends.

The OCA would also urge the Commission to adopt the risk differential between the retail return and UNE return developed by Mr. Hill which is based on adopting his proposed cost of equity including telephone companies, but using a different debt equity ratio to recognize an unregulated business situation. For UNE's Mr. Hill recognizes a far more realistic debt equity ratio would be 35% / 65% and a forward looking debt cost would be 6.79%, producing an overall return of 9.45% Exhibit 1, page 4 and Exhibit 1, schedule 12. This captures the total risk of UNE's as an unregulated telecommunications business.

Respectfully submitted,

OFFICE OF CONSUMER ADVOCATE

Dated: May 23, 2003

Michael W. Holmes
F. Anne Ross
117 Manchester Street
Concord, NH 03301
603-271-1172